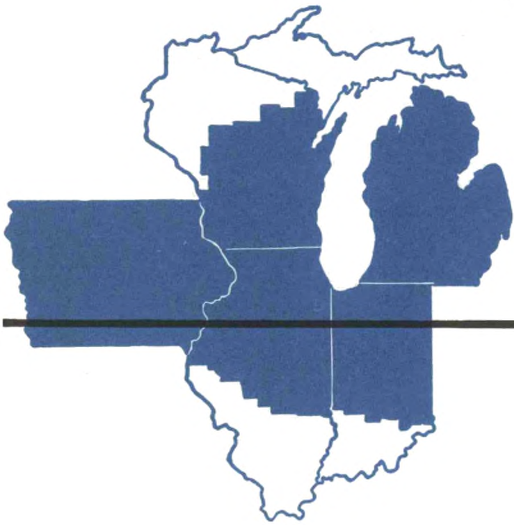
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1958 December

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THE Trend OF BUSINESS

Some slackening in the rate of growth in business activity was apparent in the early fall. To a considerable degree, this tendency is attributed to important strikes in a variety of industries. Nationally, and particularly in the Midwest, there have been walkouts in the automotive, construction machinery and farm machinery industries, to name only the more prominent examples.

Work stoppages arising out of labor-management disputes are always difficult to evaluate in terms of their impact on business trends, current and future. While strikes are in progress, output, sales and payrolls are lower than would otherwise be the case. When agreements are concluded these tendencies are reversed. But the net result of these developments seldom can be isolated from the welter of factors affecting the course of general business.

Meanwhile, the economy is moving into the Christmas season amid expectations of record sales volume. Personal income and employment, aside from strike effects, have continued to improve. Steel output in December is expected to be at the highest rate for the year, and auto assemblies for the month are projected at a two-year high.

The picture at the close of 1958 contrasts markedly with that of a year earlier. In late 1957, personal income and employment had been declining for several months, and the keen interest in the holiday trade reflected in part a hope that a good level of sales would help brake the decline.

The money market cycle

The sharp, though short-lived, decline and the subsequent brisk recovery in business during the past year and a half were accompanied by substantial changes in the financial sectors. Here, too, the wheel has turned full

Long-term rates match 1957 highs

	October 1957	June 1958	November 1958	Percentage point change October 1957-June 1958	Percentage point change 1958 low-November 1958
Treasury bills, new issues	3.59	0.88	2.75	−2.71	+1.87
Intermediate-term U. S. securities	3.99	2.25	3.58	−1.74	+1.23
Long-term U. S. securities	3.73	3.19	3.70	−0.54	+0.51
Prime commercial paper	4.10	1.54	3.32	−2.56	+1.78
Aaa corporate bonds (Moody's)	4.10	3.57	4.10	−0.53	+0.53
Aaa state-local issues (Moody's)	3.31	2.74	3.18	−0.57	+0.44

Note: Data are monthly averages of daily figures. November 1958 includes data through November 24.

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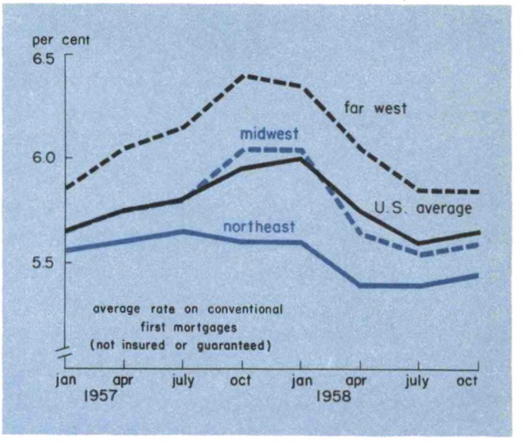
cycle. Interest rates—a useful barometer in the money markets—dropped precipitously as steps were taken to ease money and the demand for funds to buy capital equipment and build inventory diminished.

Rates hit bottom in the second quarter of 1958, approximately coincident with the trough in production. Increases since then have raised the price of borrowed funds close to the levels prevailing on the eve of the downturn in the fall of 1957. As in the case of spending and production, the movement in interest rates during this "cycle" was the sharpest of the postwar period on both the down- and the upsides.

In their attempt to promote easier money conditions, and thus facilitate the transition from decline to revival, the monetary authorities utilized all the usual tools. Open market operations, discount rate reductions and cuts in reserve requirements all were employed to make credit more available and increase the liquidity of the community. In recent months, some of these tools have been employed to restrain too rapid a rise in credit.

Mortgage rates show slight upturn



SOURCE: Federal Housing Administration.

Interest rates in retrospect

In response to lessened demand and expanded availability, short-term interest rates dropped sharply. From a monthly average of 3.6 per cent in October 1957, the yield on 3-month Treasury bills declined without significant interruption to an average of 0.9 per cent this past June.

During the last four months of 1957, long-term rates also registered sharp declines. By December, long-term Governments were selling close to a 3 per cent yield basis compared with a high of 3.8 per cent a few months earlier.

Unlike short-term rates, yields on long-term bonds stabilized in early 1958. Average yields on both high-grade corporate bonds and long-term Governments were remarkably stable from January through March. There was some further decline in yields in April and May.

Since midyear, all types of interest rates have risen. Treasury bills have fluctuated between 2½ and 3 per cent during the fourth quarter but remained well below their 1957 high. Long-term yields, on the other hand, have returned to the peak levels of last year.

Large offerings of long-terms

The heavy demands made on the long-term market during 1958 were responsible for the relatively mild decline in rates in the first half and the gains in the second half. Business firms, state and local governments, the Treasury and home buyers and builders all have taken advantage of easier capital markets to raise a large volume of money. In the aggregate, their demand actually has exceeded 1957. The volume of corporate issues for new capital (exclusive of refundings) during the January-September period

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was 8.4 billion dollars, only 12 per cent below the record volume of the same months in 1957. This occurred despite a sharply lower level of capital outlays and reductions in inventories and receivables. The volume of corporate issues sold in the first half of the year was well above the total sold in the first two quarters of 1956, a record up to that time.

Since over-all needs for funds were off far more than capital issues, it is apparent that many business firms were taking steps during the period of slack business to move into a more liquid position. Outstanding bank loans were reduced by funds raised through capital issues. Short-term bank loans declined by over 2 billion dollars during this period.

Recent surveys indicate only small gains in business outlays for new plant and equipment are in prospect for 1959. To the extent that capital issues are related to capital outlays, this would indicate no resurgence of demand for such funds in the near future at least. However, over-all needs for funds are almost certain to increase as inventory liquidation comes to an end.

State and local governments floated a record volume of bonds in the initial nine months of this year. Sales totaled 6.4 billion, compared with 5.1 billion in the same months last year and 4.1 billion in the first half of 1958. Together, corporate and state-local offerings slightly exceeded the 1957 level.

Added to these demands on the capital market has been the absorption of a substantial amount of intermediate- and long-term securities issued by the U. S. Treasury. During the first eleven months of the year, the volume of outstanding marketable U. S. securities with a maturity of over 10 years increased 3 billion dollars, and those in the 5-to-10-year maturity range rose over 5 billion dollars, with all the new intermediate- and long-term issues concentrated in the first half of the year.

Maturity	Changes in outstanding marketable U. S. securities January-November 1958
	(billion dollars)
Over 10 years	+2.9
5-10 years	+5.4
1-5 years	+5.1
Less than 1 year	—2.7

In the final quarter of 1958, new corporate issues are expected to be far below last year's level, and state and local offerings may show a decline.

Construction absorbs funds

The upsurge in residential construction during 1958 increased the amount of funds being absorbed by mortgage loans. Helped by greater credit availability and lower down payments, housing starts began to increase more than seasonally in the spring, showing gains nearly every month from April through October. The seasonally adjusted annual rate of starts in October was 1.26 million, a third above the March level.

During the first half of 1958, outstanding home mortgages increased less than 4.1 billion, compared with more than 4.3 billion in the same period last year. In the last half, the comparison has been reversed. It is estimated that the rise in the volume of residential mortgage debt will approximate 4.7 billion dollars, 400 million more than in the final six months last year.

Rates on residential mortgages have again begun to move up but are still well below the highs reached in 1957. According to data collected by the Federal Housing Administration, the interest rate on conventional first mortgages for the U. S. as a whole rose to an average of 6.0 per cent at the end of last year. By mid-1958, the average had

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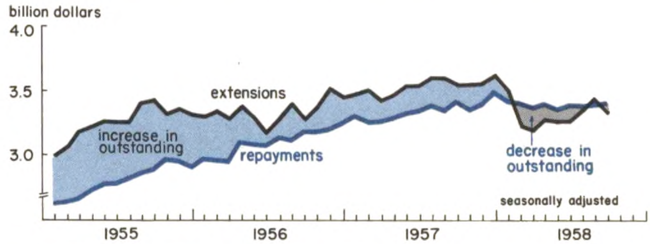
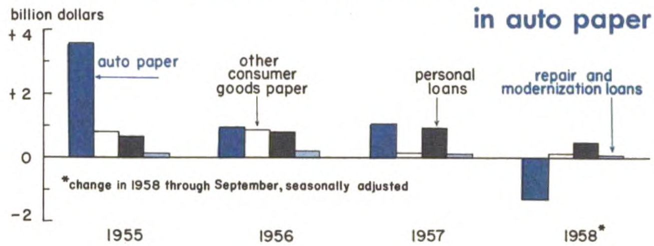
Extensions of consumer instalment loans in 1958 have dropped below repayments . . .



with decline in outstandings concentrated in auto paper



dropped by close to half a point, rising only slightly in the third quarter.

Actual mortgage rates, and changes in them, vary considerably from one region to another. In the rapidly growing western states, in which local savings generally do not meet the area's entire need for investment funds, the average interest rate, as reported by the FHA, reached a peak of 6.40 per cent toward the close of 1957. On the other hand, in the Northeast, typically a region of surplus investment funds, the average charge on conventional first mortgages rose to 5.65 per cent in the fall of last year, and by year end had already shown a decline. The spread in rates across the country has narrowed during 1958. According to data for October 1, the average rate was 5.45 per cent in the East, compared with 5.85 in the states west of the Rockies. Mortgage charges in the Midwest closely parallel the average for the nation (see chart). Recent estimates suggest a significant rise in total construction volume in 1958. No substantial further advance is expected in the residential sector, however.

Credit and consumer durables

Consumer instalment loans outstanding in September showed a decline of 257 million dollars from the year-earlier figure. The reduction in outstandings was due to the net pay-off in auto contracts. Extensions of instalment loans on automobiles during the initial three quarters of the year, after allowing for seasonal influences, were 16 per cent below the same 1957 period and 1 per cent below the 1956 pace. Repayments increased slightly from a year ago, with the result that car buyers' obligations decreased 1.3 billion dollars through September.

Other kinds of consumer instalment credit, related to the purchase of other consumer durables, repair and modernization loans and personal instalment loans—all have increased during 1958. Personal instalment loans increased 466 million dollars, seasonally adjusted, from January through September, a gain of nearly 6 per cent and the largest rise since 1954.

A strong rise in sales of automobiles would, of course, be accompanied by a rise in auto loans and probably would boost the consumer loan total. During November, the prospects for the 1959 models remained inconclusive. There was, however, some evidence that sales of appliances and homefurnishings, also important in the consumer credit picture, may be rising.

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The surge in farm income

One of the major characteristics of the economic landscape during 1958 has been the high plateau of farm income. While employment and output in most nonagricultural sectors declined and then recovered, total net farm income advanced from 11.6 billion dollars, annual rate, last year to 13.1 billion in the first three quarters of the current year. Income during the last quarter is expected to remain at the advanced level, about 13 per cent above the year-earlier figure.

This is the third time since the end of World War II that farm income has increased. The previous upturns were occasioned in part by strong foreign demand, first from the postwar shortages of food in Europe and then from the spurt in buying occasioned by the Korean War. This time, however, foreign demand has not played an important role.

Four factors share the major responsibility for the recent surge in farm income. The first factor is weather—both unusually bad and unusually good. The second consists of the coincident movements in the production cycles for hogs and cattle. Third is the willingness of consumers to actually increase their expenditures for food in a recession. And fourth is the increase in Government outlays for the soil bank and price support programs.

When put together these situations have resulted in the highest farm income since 1953.

Weather—bad and good

The weather takes top billing. Last winter it was unusually bad in Florida and across much of the South. Two separate freezes destroyed or damaged much of the fruit and winter vegetable crops. In California, the weather was less spectacular, but citrus production was reduced even more than in Florida.

The resulting shortages caused prices of these items to skyrocket. In April, for example, the index of vegetable prices rose to a record high and was more than 40 per cent above the year-earlier level. The index of fruit prices also reached a new high and was nearly 15 per cent above the April 1957 figure. A key factor in the fruit index, of course, was the citrus fruits. The price of oranges, for example, was double the April 1957 price.

These sharp price increases reflect the *inelastic* character of the demand for food. Consumers want about the same amount of food at all times. And when the quantity is reduced, competitive bidding by processors and distributors for the available supply forces prices up. Prices rise proportionately more than the decline in quantity, with the result that total expenditures for food rise. This year, for example, production of oranges dropped 18 per cent below the preceding year. Prices averaged 41 per cent higher and the total value of the crop was up 16 per cent. Thus, the bad weather of last winter boosted farm income although those individual farmers who lost their crops did not benefit by it.

During the spring and summer the weather presented a different picture, but the effects on farm income were similar. Abundant rainfall and moderate temperatures blanketed

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most of the country. One result was a record outpouring of the agricultural commodities which are widely grown and account for the bulk of total crops harvested. The over-all index of crop production this year is estimated at 118 per cent of the 1947-49 average and exceeds the previous records — 1948, 1956 and 1957—by 11 per cent. Harvests of wheat, soybeans, corn, barley, sorghum grain and some other crops have set new records. And these records are being set on the fewest acres under cultivation since World War I.

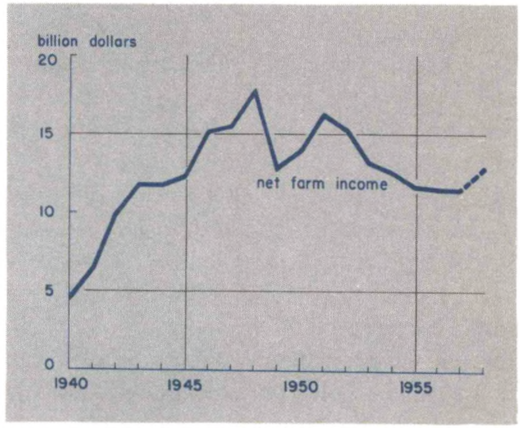
The demand for these commodities also is inelastic, even more inelastic than the demand for winter vegetables and fruit. Thus, a larger supply would be expected to cause a sharp decline in prices. However, the existence of Government price supports has prevented prices of most of these crops from dropping very much. Therefore, receipts from the marketing of these commodities increased nearly proportionately with output.

Federal outlays on price supports, of course, have increased substantially. Outlays for the price support programs of the Commodity Credit Corporation in the year ending June 30, 1959, were estimated in January to total 2.4 billion dollars. As of midyear, the estimate was revised to 4.0 billion, and crop output estimates were raised further after midyear. Thus, both the unusually bad weather last winter and the unusually good weather this spring and summer contributed to the rise in farm income in 1958.

A symphony of cycles

Meat animals, too, helped to swell the farm income stream. Cattle and hogs both show wavelike fluctuations in the numbers produced and marketed. It is quite unusual for these cycles to move in concert. However, marketings of both increased in 1955-56 and

Net farm income at highest level in five years



decreased in 1957-58. This coincidence of supply patterns caused much larger price changes than if the cycles moved independently. And since the demand for meat, too, is inelastic, although less inelastic than the demand for many other foods, the farm income response tends to be in the same direction as the price change and opposite to the supply change. Hence, large supplies in 1955-56 depressed prices of both cattle and hogs to the lowest levels since World War II. In part, the reduced supplies and higher prices and incomes from meat animals in 1958 reflect farmers' adjustments to the low prices in 1955-56, especially as to hogs.

In cattle slaughter, the weather has played a dominant role. Following several years of drought in important cattle grazing areas, rains in the summers of 1957 and 1958 provided lush grass and cattlemen began rebuilding breeding herds. The withholding of cows, heifers and calves for herd expansion has resulted in a large reduction in cattle slaughter. Coinciding with the cycle in hog supplies, the result was the highest prices for cattle last

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spring since 1952 and the highest prices for hogs since 1954.

No recession in food expenditures

The third factor which helped to boost farm income has been the increase in consumer expenditures on food. For the first eight months of 1958, sales of food stores are estimated to have increased 5 to 7 per cent over the comparable period last year. This resulted largely from the short supplies of certain highly desired foods. As consumers try to maintain their consumption, the resulting higher prices raise total food expenditures and farm income.

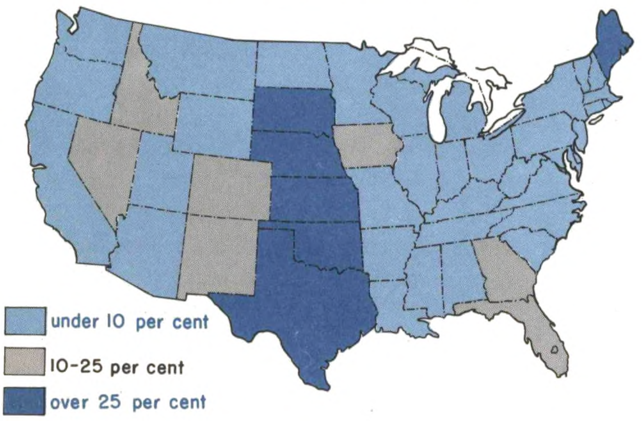
The increase in food expenditures possibly would have been larger if there had been no recession. Personal income declined slightly —from an annual rate of 352 billion dollars in the third quarter of 1957 to 350 billion in the second quarter of 1958—and unemployment increased from 2.6 million to 5.1 million in the same period. However, personal consumption expenditures for food and alcoholic beverages increased from 77.1 billion to 78.6 billion dollars. An increase of nearly 5 billion dollars in unemployment compensation payments and other similar Federal outlays helped maintain spending for commodities such as food. It is significant also that expenditures on consumer durable goods in the same period fell from an annual rate of 40.4 billion dollars to 35.6 billion, most of the decline being accounted for by automobiles and parts. Many households apparently shifted spending from durables to food during the recession.

The geography of farm income

Most areas have experienced increased farm income in 1958. The sources of the income gains, and the causes, have varied by area. Receipts from sales of crops jumped dramatically last spring in Florida, Texas and Arizona after the southern freeze brought high prices for commodities produced in that area. California, however, experiencing an even poorer citrus crop than Florida, had a decline in cash receipts from crops compared with the year-earlier period.

Farmers' gross sales rise sharply, wheat and cattle areas lead rise

per cent change from year ago



In the Great Plains and Southwest, from South Dakota through Texas and New Mexico, farm income reflected both record crops and high livestock prices this year. Kansas and Oklahoma had increases of more than one-half in cash receipts from marketings the first nine months this year. Texas, Nebraska and Maine reaped increases of more than a third. The increase in Maine was due to high prices for potatoes in storage after the failure of the winter crop in the South. New Mexico and South Dakota posted gains in cash receipts of more than one-fourth. The increases in cash receipts in

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the Great Plains and Southwest come after several years when drought had held incomes to relatively low levels.

In the Seventh District, Iowa has posted a gain of 14 per cent in cash receipts over last year, part of which is due to delayed marketing of last year's corn crop. However, this gain brings Iowa only slightly above the 1953 level of cash receipts because drought in the intervening years had depressed income in that area. Illinois and Indiana, on the other hand, are running only 4 per cent above last year, but this level has remained relatively constant for several years. Cash receipts in Wisconsin have been above last year's level until this fall, while Michigan has shown no change. These states have had one of the few drought areas in the nation this year.

Gross and net farm income

	1953	1954	1955	1956	1957	Nine months 1958*
			(billion dollars)			
Cash receipts from farm marketings	31.1	30.0	29.5	30.5	29.7	32.9
plus						
Realized nonmoney income	4.0	3.6	3.6	3.5	3.6	3.5
plus						
Government payments	.2	.3	.2	.6	1.0	1.2
equals						
Realized gross farm income	35.3	33.9	33.3	34.6	34.3	37.6
less						
Farm production expenses	21.4	21.7	21.8	22.5	23.5	24.5
equals						
Realized net farm income	13.9	12.2	11.5	12.1	10.8	13.1
plus						
Net change in farm inventories	—.6	.5	.3	—.5	.8	0
equals						
Total net farm income	13.3	12.7	11.8	11.6	11.6	13.1

*Annual rate.

More of the same?

Some of the factors that pushed farm income up in 1958 will remain operative in 1959: continued rebuilding of cattle breeding herds, improved farm technology, short supplies of citrus fruits and high levels of consumer demand. But the full sequence of income-boosting events is not likely to recur.

Hog producers have reported plans to increase spring farrowings in the magnitude of 15 to 20 per cent. An increase of this size in output of pork would likely cause a large drop in hog prices and some reduction in income from hogs in the second half.

With more normal weather, the winter vegetable crop should be larger than last year, indicating lower prices and smaller cash receipts from that source. Prices of citrus fruit are well above year ago at the beginning of the season and promise to remain high in the months to come, although

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possibly not so high as in the current year.

For the major field crops, 1959 receipts will be supported somewhat by the continued large volume of marketings in the first half from the record 1958 harvest. Receipts from marketings the last half of the year will depend largely on the size of the harvest which cannot be foreseen at this time. While there has been a strong upward trend in yields in the postwar period, it would seem unlikely that the exceptionally high per-acre yields realized in 1958 would be repeated next year. However, the acreage reserve program of the soil bank has been discontinued, which could return to production 17 million acres of crop land withheld from harvested crops in 1958. On the other hand, the conservation reserve program of the soil bank has been expanded and will provide at least a partial offset in terms of the planted acreage.

Uncertainties exist with respect to support prices and farm production costs as well as to the volume of agricultural marketings. Government payments authorized for next year under the conservation reserve have been increased nearly 300 million dollars, but this only partially offsets the elimination of 700 million in acreage reserve payments made this year.

Obviously, any projection of farm income may be wide of the mark. Based on present indications, the U.S. Department of Agriculture has concluded that net farm income in 1959 may be from 5 to 10 per cent lower than in 1958. If so, 1959 could be the second best year in the last five. At this time, such a projection appears plausible for the Midwest as well as for the U.S.

Aid to the ailing railroads

The past year has seen an almost unprecedented flood of comment—official and nonofficial alike—on problems confronting the nation's railroad industry. A leading item on the Congressional agenda earlier in the year, moreover, was the prolonged and searching debate on a variety of controversial legislative proposals which were offered to deal with the carriers' troubles. A significant result was the passage of the Transportation Act of 1958 and repeal of the 3 per cent Federal excise on freight charges.

These measures add up to an expression of Congressional and Administration sympathy for the carriers' problems. It seems quite unlikely, however, that this is the end of the matter, even for the time being. For one thing, industry spokesmen predict that their call for elimination of the 10 per cent Federal tax on passenger fares will be renewed at the next session of Congress. Furthermore, by adoption of Senate Resolution 303 in the closing days of the 1958 session, the Senate acknowledged that a good deal of unfinished business remains. The resolution calls for a special interim study of a number of specific problems, presumably presaging further legislative deliberation.

Government loan guarantees

The urgency of the financial condition of some carriers is dramatized by a provision in

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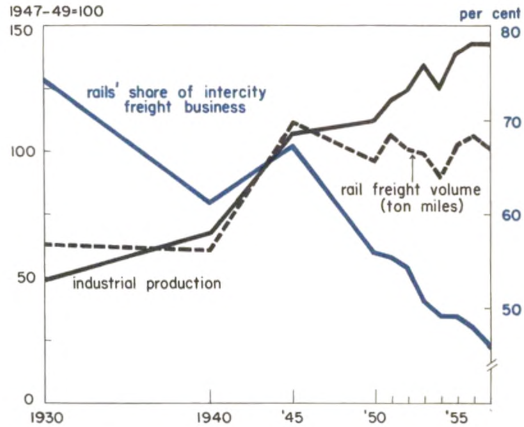
the new Transportation Act setting up a loan guarantee program. By its terms, the principal and interest on loans to railroad companies for capital or property maintenance purposes may be guaranteed by the Interstate Commerce Commission. This authority will extend until two years from next March 31 and is retroactive, in the case of borrowings for capital purposes, to January 1, 1957. To qualify for guarantee, a loan must not exceed a term of fifteen years. In addition, the Commission must be satisfied that without the guarantee, funds could not be obtained "on reasonable terms," that the loan interest rate is not "unreasonably high" and that the borrower is able to give "reasonable assurance" of ability to repay its debt. It is further provided that no dividend is to be paid by any carrier obtaining a guaranteed loan for maintenance purposes so long as any portion of the loan remains unpaid.

Thus far, there has been no line-up at the I.C.C.'s loan guarantee desk. Three hard-pressed eastern roads have filed applications, two major New England carriers and a short line in New Jersey. The loans in question are for capital purposes. To date, no carrier has shown any interest in guaranteed borrowing to cover maintenance outlays. Some observers contend that this feature of the program is not likely to prove popular, if only because of the dividend ban which it carries. Leading industry spokesmen have questioned the likely usefulness of the whole loan guarantee plan, pointing out that the eligibility test may be so stringent as virtually to rule out widespread use of the new measure.

From testimony presented during hearings on the legislation, it is clear that impairment of the rails' cash position was a matter of deep concern at times during the recent slump in business activity. Fears were expressed of an imminent inability on the part of certain roads even to meet their payrolls. While the guarantee program does not extend to borrowings for operating expenses in general, its applicability to loans for maintenance outlays could serve other objectives indirectly. A carrier short of cash to meet its most pressing requirements would ordinarily be able to show a sizable volume of deferred maintenance, borrowing for which is eligible for guarantee. The improvement in business under way for the past several months, however, appears to have relieved some of the stringency. As a result, guaranteed loans for maintenance purposes appear to be a fairly remote possibility, barring any sharp reversal in business trends.

Rail freight volume well above prewar, but lags industrial output, reflecting inroads of competition



Changes in regulatory climate

Other provisions of the new Transportation Act deal with the highly involved matter of public regulation of the railroads and their competitors. One of these seeks to forestall appreciable further lengthening of the list of agricultural products which may be trans-

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ported free of regulatory control by the Interstate Commerce Commission. Another section denies to nontransportation companies the right to engage in the business of moving goods by motor carrier for the account of others than themselves. A third serves to strengthen the hand of the Interstate Commerce Commission in the establishment of *intra*state fares and rates which are consistent with Commision-approved *inter*state charges. The two remaining features of the Act are perhaps the most significant of all, since they have important implications for the rails' well-known passenger deficit problem and the touchy matter of rate relationships among different kinds of public carriers.

Cutting passenger losses

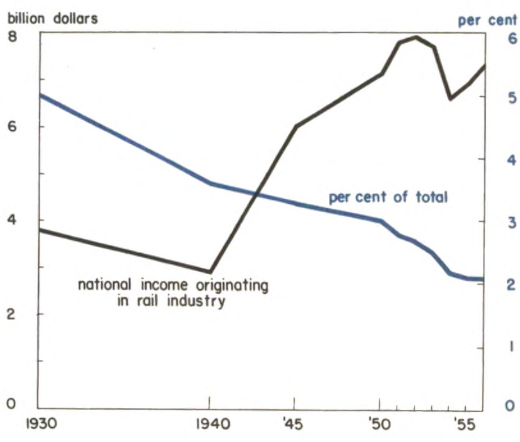
Almost without exception, the railroads regularly report operating deficits in passenger operations. Just how great these are is a matter of dispute, and the extent to which they can be reduced involves judgments and assumptions about joint costs and the competitive situation of the rails as passenger carriers. Using rules prescribed by the I.C.C. for separating freight and passenger revenues and expenses, the industry deficit is on the order of 700 million dollars.

Reducing or abolishing passenger operations will have a proportional impact on such items as revenues, wages of train crews and the cost of locomotive fuel. At the other extreme are expenses that have to be incurred whether passenger service is operated or not, e.g., the salaries of executive personnel and a certain level of roadway maintenance costs. Such outlays can only be allocated between freight and passenger operations on an arbitrary basis. More important than either of these categories in shedding light on the potential of deficit-paring moves are costs that can be avoided by shearing away passenger service entirely. This drastic action opens the way to elimination of exclusively used facilities and entails reassessment of the precise needs of the freight service.

In any event, it is no easy task to measure the passenger deficit or, for that matter, even to quantify its vulnerability to cost-cutting assault. But the fact that carriers with relatively heavy passenger operations generally fare less well than those having little or no such service supports the view that accommodating travelers is a costly business.

Widely prevalent at the present is the doubt that further upward adjustment of fare levels offers promise of material relief as far as a big share of intercity passenger service is concerned. Competition of the air and highway common carriers and the private automobile is so keen that traffic diversion to these media could be expected to outpace the effects of rail fare increases. The prospect may, however, be different in the case of local passenger operations tying

Income generated by the railroads is a declining share of total national income



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outlying residential communities to the downtown sections of some of the bigger cities.

Commuters: a special problem

Suburban passenger service, in the judgment of the score or so railroads which provide it on a sizable scale, is about the most highly productive of deficits of all the services they offer. The reason is not far to seek.

With the coming of age of the automobile, patronage has become increasingly concentrated at two peak periods, of about two hours each, five days a week. Ridership at these times is about as great as ever, while off-peak volume is down sharply. The reduction in midday traffic has led to no commensurate saving in over-all operating expenses, since manpower and equipment assignments are geared to requirements at the peak periods. But the loss of off-peak traffic has had an adverse effect on revenues.

Some observers point out that the rate preference characteristically accorded regular rush-hour riders and the failure of existing fare structures to incorporate the "demand-charge" feature found in utility pricing practice are inconsistent with the fact that, in their present-day setting, suburban operations are carried on almost solely for such users. Revenues earned in about 20 hours of each week must necessarily cover the whole of operating expenses.

Recent trends are in the direction of providing tailored commuter services with modern specialized equipment, instead of obsolete, uneconomical rolling stock, and a structure of charges aimed at recovering outlays from those riding regularly. Since the costs and inconvenience of alternative ways of getting to and from work are far greater to most commuters than those connected with the rail service they use, this is one type of passenger operation which the industry may succeed in placing on a self-sustaining basis.

Adjustments of fares and schedules—in either intercity or suburban service—are actions that usually require consent of the regulatory authorities. Up until now, state public service commissions have held sway exclusively in this field. By the terms of the new Transportation Act, railroads seeking to discontinue or otherwise change their passenger services may petition the Interstate Commerce Commission directly if the rail (or ferry) service is interstate in character or "appeal" to the Commission any unfavorable decision handed down by a state authority in an intrastate case. The carriers contend that in the past some state regulatory agencies have unduly resisted passenger service and fare changes, largely out of deference to local pressures, and they believe that the Federal Commission will be able to deal with their applications somewhat more objectively and with a clearer conception of systemwide financial implications.

Rate relationships

In 1940, the Interstate Commerce Act was amended to incorporate a definition of the national transportation policy. This calls for impartial regulation of the various modes of transportation to the end that the "inherent advantages" of each will find expression and "unfair or destructive competitive practices" may be avoided.

It has long been a contention of spokesmen for the railroad industry that frequently in cases involving intermode freight rate relationships, rail charges have been held up by the Commission to protect or afford an "umbrella" over rate structures of their nonrail competitors. Suppose, for example, that a rail rate between A and B is $1.00 a ton. A truck line offers a rate of $1.10. The 10-cent difference is less than enough to offset

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the service superiority of the truck operation, so all the traffic shifts to the truck line. Thereupon, the railroad offers a rate of 90 cents. At this level, its rate appeals to the shippers and it regains some or all of its lost traffic. The Commission, however, steps in at the behest of the trucker to bar the cut in the rail rate, on the ground that this would constitute unfair competition or would fail to recognize the advantage of the trucker.

The rails argue that in a case like this the inherent advantage may well be theirs and that it will be if the lower rail rate covers out-of-pocket cost and also makes some contribution to overhead. Incorporated in this year's Transportation Act is a provision adding new language to the so-called Rule of Rate Making applicable to railroads under the Interstate Commerce Act. In essence, it transcribes into statutory form language that has appeared in I.C.C. decisions from time to time to the effect that rates of a given carrier shall not be held up to a particular level to protect the traffic of any other mode of transportation. But it then goes on to assert that recognition must be given to objectives of the national transportation policy.

The net result appears to be that the rates of a rail carrier shall not be held up to protect the rates of a nonrail carrier, but the inherent advantages of all modes shall be preserved and unfair or destructive competition shall be prevented.

Rates and "cost"

All agencies of transportation use equipment and require manpower to operate it. Both railroads and highway carriers, moreover, use fixed way over which to run their vehicles. The railroads provide their own right of way, recouping their outlays on it in the form of the fixed charges or "overhead" they are able to earn. Truck lines, however, pay for their right of way as they use it, by means of motor fuel taxes and other user charges. Virtually all of a truck line's operating expense varies directly with traffic volume. A "compensatory" truck rate is not easily shaded downward to meet a competitor's lower quotation. (An important exception is the rate that can be charged to carry goods on what would otherwise be an empty back haul.) The reason is that almost all the cost a highway carrier sustains must be met currently out of pocket. A "comparable" rail rate, however, will include a sizable share of cost bearing no direct relationship to the volume of traffic moved.

While a rail carrier may strive to secure a pro rata contribution to overhead from every shipment, any contribution, however small, is better than none. For a time a railroad can exist on rates that yield little more than out-of-pocket or direct expense. In the long pull, though, fixed expenses must be covered. A rate below "full" cost but more than equal to out-of-pocket cost is profitable to the rail carrier, when the alternative is a full-cost rate which will move no traffic. The great importance of fixed costs to the railroads makes for a sizable gap between full and out-of-pocket cost and therefore vests in management a wide range of discretion in competitive rate making.

This difference between the railroads and the highway carriers is accentuated by their relative positions with respect to excess capacity. The operator of a truck fleet can offer additional service by purchasing or leasing additional equipment at something like the average cost of providing existing capacity. Added right-of-way needs are bought out of pocket as required and on the same terms as right of way used by the initial fleet. As far as equipment is concerned, the railroad stands on substantially the same

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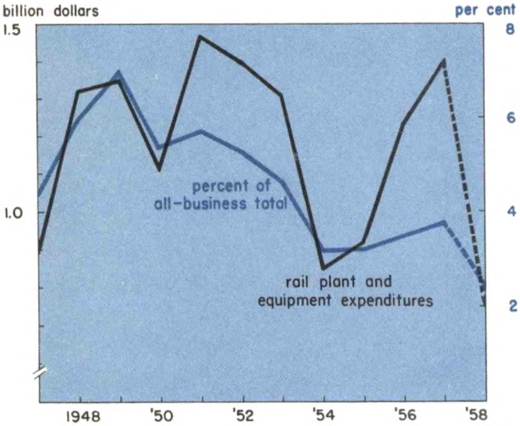
Railroads' postwar capital spending shows sharp year-to-year swings



footing as its rival, but there the resemblance ends. The need for additional right of way is met simply by drawing on under-utilized capacity already installed and paid for.

Part of the reason for the under-utilization of rail right of way lies in the fact that the scale of plant must necessarily be geared to service peaks. Transportation service is not storable and, insofar as it is the product of trackage and other fixed facilities, it is not itself transportable. The rail network as a whole, therefore, consists of a multitude of segments individually tailored to specific maximum rates of use. Generally, but not without exception, each one has a service potential well in excess of demands customarily placed upon it.

Technological developments have contributed to overcapacity also, by serving in some cases to alter the required "mix" of line facilities and rolling stock making up the railroad plant. Improvements in signaling and communications installations and increasingly capable motive power and rolling stock have speeded up and permitted the lengthening of trains, thereby reducing the scale of investment in fixed way needed to carry on operations.

For a variety of reasons, then, today's railroad plant incorporates a sizable pool of partially untapped productive potential. Its presence has important implications for the direction and intensity of the industry's responses to competitive pressures.

Monopoly price policy

Traditionally, and particularly before the rise of motor-carrier competition, a hallowed rule in the rail industry was to charge according to "what the traffic will bear." In practice, this meant low rates on low-valued, bulky goods; high rates on high-valued, less bulky commodities. Rates on both classes exceeded out-of-pocket cost, but the contribution to fixed expense came predominantly from the higher rates. Such a rate structure as this, of course, later became a tempting invitation to competition from the rising highway carrier industry and from private and exempt carriers. The trucks, in a position to specialize as freight carriers, naturally tended to win the traffic on which the rails were at a comparative rate disadvantage, while leaving the less-profitable, lower-rated commodities for their established rivals. The rails, in short, began to lose the traffic which had been generating most of the coverage of their fixed expenses. In an effort to save the day, on the precept that any recoupment of overhead is better than none, they responded by paring their higher rates to competitive levels.

Monopoly pricing is characterized by an orientation toward forces on the demand side of the market. Competitive pricing, on the other hand, largely faces toward costs, on the side of supply. The rise and subsequent intensification of competition in transporta-

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tion, therefore, have tended to focus attention increasingly on the costs of carrying goods. But, like the relative costs of conducting freight and passenger operations, the expenses connected with particular classes of freight movement, not to mention particular shipments, are exceedingly difficult to ascertain, if, indeed, they are susceptible of precise quantification at all. In good part because of this difficulty, such concepts as full cost and out-of-pocket cost mean different things in different circumstances and therefore offer little in the way of objective guidance in the construction of rate schedules. In practice, virtually every case is unique, and must be resolved on its own merits.

Under the discipline of competition, carriers of the same as well as different modes may be expected, with some reservations, to achieve working interrelationships compatible with the community's interest in the expression of inherent advantages. Important in this context, however, is the maintenance of regulatory safeguards against the practice of predatory competition, i.e., transitory rate reductions designed to eliminate rivals, and the exaction of monopoly charges in instances where effective competition for one reason or another has failed to develop.

1958 Act no panacea

By this time, it is evident that the new legislation will scarcely solve the "railroad problem." Perhaps it will induce the I.C.C. to grant the rails more latitude than in the past in scaling down their charges to recapture traffic lost to their competition. But it is unreasonable to suppose that the Commission will be disposed to ignore altogether the side effects of rate cuts on other modes of transportation.

Making it somewhat easier for the carriers to drop unprofitable passenger services should have, on balance, a salutary effect on their financial results. But, many will hope for revival of a spirit of innovation and experimentation, particularly in the construction of fare schedules, lest some users be deprived of services they might be willing to support at a profit to operators, given an opportunity to buy at realistic prices.

The rail industry's substantial overcapacity, found conspicuously in terminal facilities and main-line mileage, remains a problem. Repricing of services may prove effective as a way to appreciably fuller use of existing plant. The alternative, however, would appear to be a process of disinvestment carried to the point where capital requirements and costs, and, to some extent, operating expenses, were more precisely geared to industry demand than is now the case. The I.C.C. recently has intimated that it would review sympathetically carrier proposals for broad-scale consolidation. A fair number of plans already are in the stages of planning and discussion. Together, these developments suggest that the achievement of material savings in both operating and capital outlay may not be far off. Several of the mergers under consideration appear to offer genuine promise, since they would entail the combination of companies which operate duplicating terminals and lines.

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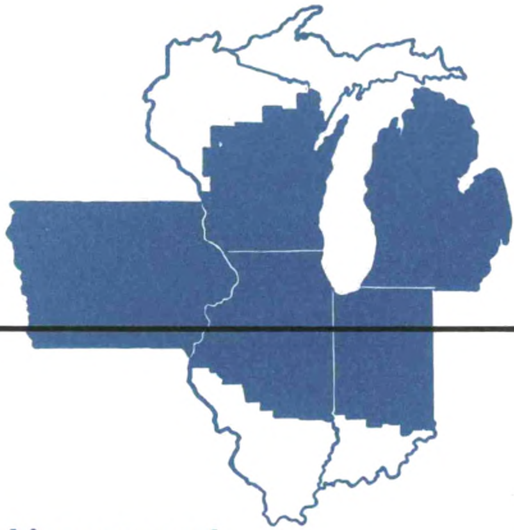

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a review by the Federal Reserve Bank of Chicago

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